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# Research Corner: The Federal Student Loan Programs Need Better Metrics and Default Aversion

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*Although postsecondary education institutions are responsible for keeping default rates low, the current measure of cohort default rates only examines defaults that occur within the borrower's first and second year of repayment. At the Student Loan Repayment Symposium, held in Washington, DC on October 2-4, 2000, financial aid professionals concluded that the two-year measure of cohort default rates on federal student loans is not representative of actual default experience over longer periods. It is time to follow up on this conclusion. This article considers alternative ways of measuring defaults in the student loan programs, and recommends a follow-up symposium leading to the establishment of a national task force.*

Under the current student loan system, the primary burden for preventing defaults rests with postsecondary education institutions. Title IV of the Higher Education Act gives the U.S. Secretary of Education the authority to limit, suspend, or terminate institutional participation in the federal student loan programs of any school with a cohort default rate that reaches 25% or more for three consecutive years.

More than 6,400 colleges, universities, and proprietary schools are accountable for controlling the cohort default rate (GAO, 2003). However, the current default rate system measures only defaults that occur in the borrowers' first and second year of loan repayment. The cohort default rate measure is only an indicator, and one that understates the actual default rate over the life of the loan.

Nevertheless, 1,200 schools (mostly private for-profit, or proprietary) have been suspended from Title IV eligibility for exceeding the cohort default rate (General Accounting Office [GAO], 2003). This fact demonstrates that enforcement of the cohort default rate has been borne primarily by schools, at least since the early 1990s when the Title IV eligibility ceiling was arbitrarily set at 25%. However, the cohort default rate has dropped significantly for all schools since it peaked at 22.4% in 1990 (GAO, 2003).

Currently, few four-year colleges and universities have cohort default rates in excess of 10%. It has been noted that default cutoffs tend to be imprecise policy tools that do nothing about institutions with very high rates of default that are nonetheless below the cutoff level (Gladieux & Hauptman 1995, p.52).

Such observations suggest it is time to revisit these issues to determine if the system is working at its optimum level for the current environment.

Financial aid professionals at a Student Loan Repayment Symposium (the Symposium), held in Washington, DC from October 2-4, 2000, concluded that the two-year cohort default rate window was not representative of actual default experience over longer time periods, because "lifetime default rates are roughly double the two-year cohort rate. That's a lot of students having trouble repaying their loans" (Woods, 2001, p. 12). At the Symposium, there was overwhelming support for measuring the life of loan default rates. However, little has been done to follow up on this recommendation. The lack of movement in this direction may be attributed to the decline in the national cohort default rate, from 22.4% in Fiscal Year (FY) 1990 to 5.6% in FY 1999 (GAO, 2003). These declines may have diminished national concern. Meanwhile, in absolute numerical terms, more student borrowers are defaulting on larger accumulated debts.

The College Board's *Trends in Student Aid* (The College Board, 2002) indicates that state and federal grants, while increasing in actual dollars, have historically declined over time relative to loans as a percentage of total financial aid. In 2001-2002, students borrowed $48 billion or 53% of total financial aid. Consequently, borrowing from federal or private loan programs will likely continue to increase. A recent National Student Loan Survey published by Nellie Mae found that in 2002 the average undergraduate debt was $18,900, up 66% from $11,400 in 1997 ( Baum & O'Malley, 2003). Therefore, we should anticipate much larger per capita borrowing.

## Evidence of Increased Borrowing

Since the inception of the federal education loan program in the mid-1960s, students and their parents have borrowed $300 billion to finance the cost of college. It took American families 30 years to borrow the first half of this amount but only five years to borrow the second $150 billion (Scherschel, 2000). The social and economic drivers fueling this growth in borrowing are the escalation of tuition and the explosion of college-age students and older non-traditional students (Advisory Committee, 2001). Further, the inception of the unsubsidized Stafford Loan Program and expanded loan eligibility requirements have contributed to the sharp increase. As a result, the demand for student loans has been growing at a rate in excess of 10% a year (Connor, 2002).

According to data published by the GAO, Federal Family Education Loan and Direct Loan portfolios amounted to $160 billion and $73.2 billion respectively in fiscal year 2001. Loans in default were listed at $21.8 billion, or 9.4% of the loans outstanding. These figures are adjusted downward to reflect amounts collected during FY 2001 (GAO, 2003). Sallie Mae places the amount of federal loans in default at $32 billion (Whorley,

2003). The difference may be explained by the federal accounting method, which defines some loans as "currently not collectible" as opposed to actual defaulted loans receivable.

The importance of debt management at the national, institutional, and borrower level will become of even greater significance as the next wave of new college-age students start to apply for financial aid. According to *Projections of Education Statistics to 2012* (NCES, 2002) there will be a 15% increase in college enrollment from the actual 15.3 million in 2000 to an estimated 17.7 million in 2012.

Further, the Advisory Committee on Student Financial Assistance reports that 80% of the increase will be non-White students, and 50% will be Hispanic. Higher percentages of students will be from lower-income families with higher unmet needs (Advisory Committee, 2001). Increasing demands for more loans to finance the higher education of high-risk populations will create a need for even better loan default aversion strategies than are in place today.

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Debt burdens need to be better understood in human and statistical terms to devise default aversion strategies that work. Bateman and Fossey (1998) argued, "Appreciably higher student loan levels represent almost as significant a development in federal aid policy as the GI Bill or the original Higher Education Act of 1965" (Bateman & Fossey, 1998, p.71).

The question of how much student loan debt is too much has been debated for many years. In her article, *Is the Student Loan Burden Really Too Heavy?* Sandy Baum issues a warning: "It would be irresponsible not to emphasize the real danger that the prospect of high debt may discourage vulnerable population groups from participating in higher education" (Baum, 1996, p. 35).

Increasing student loan debts brings into question how much debt is manageable by the average person with a job. Using guidelines from the U.S. Department of Housing and Urban Development, Greiner places the limit for non-mortgage debt at 12% of gross income for auto loans, student loans, credit cards and other consumer debt. Greiner analyzed several surveys to conclude that student loan debt exceeding 8% of gross income is burdensome (Greiner, 1996).

A recent report titled *The Burden of Borrowing*, published by the Higher Education Project of the State Public Interest Research Group in 2002, found that an estimated 39% of student borrowers are graduating with "unmanageable debt," estimated to be in excess of 8% of an individual borrower's gross monthly income. The report, based on data derived from the U.S. Department of Education's Year 2000 National Post Secondary Student Aid Study, found that in the last eight years, the average debt among student borrowers has nearly doubled to $16,928 (Kellogg, 2002).

Additionally, private alternative borrowing is on a rapid upswing, rising from $1 billion in 1995-1996 to about $5 billion in 2001-2002 (The College Board, 2003). The good news is that for those with jobs, salaries are up and interest rates are low; both factors are helping to keep many current borrowers from defaulting. However, students' attitudes toward loans appear to be at a turning point.

The Nellie Mae-sponsored 2002 National Student Loan Survey report revealed that only 59% of students agreed that the benefits of incurring student loans are worth it. Another 20% were neutral. Compared with earlier surveys, this was the lowest percentage to give this response to this question. Percentages of students who gave this response were 66% in 1997, 74% in 1991, and 68% in 1988 (Baum & O'Malley, 2003).

## Options for Reducing Defaults

In the late 1980s, Congress placed more responsibility for default aversion on the 3,500 lenders in the Federal Family Education Loan Program (FFELP). This was dropped after heavy lobbying by the lenders. Through guaranty agencies, the U.S. Department of Education now reimburses lenders for 95% of the cost of lost principal and accrued interest on defaulted loans. Lenders would resist increased lender risk-sharing, which might cause higher borrowing costs. Raising student borrowing costs or federal loan subsidies is unacceptable to most policy makers. Some lenders may leave FFELP if subsidies are reduced or profit margins narrowed. Therefore, this policy option of increasing lender risk-sharing is unlikely to gain support.

According to Symposium participants, new approaches must be tested. The declining national cohort default rate, while impressive, will likely increase in times of high unemployment, such as in the current economic cycle. In fact, the cohort default rate has already increased from 5.6% in FY 1999 to 5.9% in FY 2000 (GAO, 2003). Symposium participants said that the goals for default risk-management policy need to be evaluated with respect to future demographic shifts. Panelists noted we should consider legal, regulatory, and management changes that could lead to process improvements. They indicated that we need a more complete understanding of loan default behavior over the life of loans, best practices in risk aversion among partners, better targeting of high-risk populations for outreach education, early warning systems based on both students and dollars in default, incentives for repayment behavior modification, and risk-sharing and alignment of policy changes at the federal, state, and institutional levels.

## Consequences of a Failed Policy

Every borrower in default has his or her own story. They face credit limitations, debt collectors, garnishment of salaries, and even personal bankruptcy. Their lifestyles can become diminished—just the opposite of the purpose of higher education. Being a defaulted borrower can be a serious detriment and an

unfortunate outcome of seeking higher education. On a national level, it is a failure of policy. In the book *Condemning Students to Debt*, Bateman & Fossey state:

> In recent years, loan volume has ballooned—more than doubling in six years. Together—rising volume, poor program management, and ever more burdensome individual debt loads could portend a resurgence of student loan defaults to a magnitude never seen before. Even if default rates stay down, growing debt loads will negatively impact millions of individual borrowers who are burdened with onerous long-term payments. Ultimately, the cumulative strain on these individual debtors will surely affect the national economy. (Bateman & Fossey, 1998, pp. 7-8.)

## Recommendations

With the cohort default rates at historic lows, it is a good time to build on past accomplishments before the rates increase. A new, longer-term measurement system is needed to replace or perfect the cohort default rate calculation method. Default aversion strategies should be developed to target the various "at risk" student populations with differing default and repayment behavior. One approach to identifying these populations is to replace the single default-rate ceiling with peer group benchmarks, with higher or lower ceilings set according to peer group experience. Consider the historical defaults by type of school below (Connor, 2000):

Cohort Default Rate Percentage
Average FY94 – FY99

| | |
|---|---|
| Public 4-year | 6.35% |
| Private 4-year | 5.63% |
| Public 2-year | 12.25% |
| Private 2-year | 12.0% |
| Proprietary | 15.9% |

The data above suggests at least three groupings. While four-year schools have low default rates, they enroll the largest number of students and most of the cohort default dollars. Approximately 70% of default dollars come from borrowers at four-year institutions (Woods, 2001). From a default risk-management perspective and the perspective of the tax-paying public, knowing where dollars are in default is fundamental in any form of credit management. It is just as important to be aware of large-dollar schools with escalating default rate trends as schools with high default rates and small dollar amounts in default. All require monitoring and some remediation.

Restructuring financial incentives for guaranty agencies is another option. According to Woods (2001), "The current

structure is 'upside down' because it pays guaranty agencies to cure (collect) defaults and puts much less emphasis on preventing defaults." Guaranty agencies need a workable compensation formula to focus their activities on borrowers who fall behind in their payments so agencies can intervene before borrowers default." (Woods, 2001) The nature of this restructuring problem is best illustrated by these words from Paul Combe of American Student Assistance, a guaranty agency:

> If all students could be spared the problems of default through a guarantor's default aversion assistance efforts, Federal Student Aid's (FSA) cost would drop to one-sixth the normal level, but the guarantor's gross revenue from all sources would drop almost 50%. If, however, the guarantor were unsuccessful in preventing any students from defaulting, its gross revenue would increase almost threefold while the cost to FSA would increase fourfold. (As quoted in Woods, 2001, p. 49.)

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Improvements in outreach to students and parents at every stage of the borrowing process—high school, college, grace period, repayment, and default—have been recommended by experts on almost every level. According to a Harris Poll commissioned by The Sallie Mae Fund,

> Among families making less than $50,000 per year, 60% said they need more information about how to pay for college, versus 37% of those making more than $75,000 per year. Nearly half (45%) of the parents surveyed with income less than $25,000 per year said they have no idea how they are going to pay for college. (Sallie Mae Fund, 2003, pp. 1-2).

As a result of the poll, the Sallie Mae Fund has funded a three-year $15 million program called "Project Access," a community outreach and education program.

"Project Access" is to be commended. It fills an unmet need and illustrates the willingness of the education finance community to help fill changing needs. Support for programs such as "Project Access" and other good ideas are another reason to hold a conference. Good ideas need to be synthesized and action plans proposed. It is time for a national task force of schools, lenders, guaranty agencies and other stakeholders to develop new proposals and consensus to follow up on the recommendations of the October 2000 Student Loan Repayment Symposium.

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